Asset Location: The Free Lunch

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Studies have shown that asset allocation – choosing which asset classes to invest in and in what proportion – is the largest driver of portfolio returns. In other words, selecting the appropriate allocation among equities, fixed income, and alternatives drives performance to a much larger degree than the underlying investments themselves. That being said, many investors fail to also consider the importance of asset *location* – that is, choosing how their investments are allocated among various types of accounts (IRA, joint, etc). There's an old adage that says "There's no such thing as a free lunch" (ie. getting something for nothing) – however, making the right asset location decisions is an easy and "free" way to increase investment returns on an after-tax basis.

Assume an investor has a taxable account worth $4,000,000 and an IRA worth $1,000,000 and wants to invest 80% in stocks and 20% in bonds. The investor can either: 1) place the stocks in the taxable account and bonds in the IRA; or 2) place the bonds in the taxable account and spread the stocks across both accounts. Because IRAs generally have long time horizons, intuition tells us these accounts should contain "growthy" assets and thus favor an allocation to stocks over bonds. However, keep in mind that funds distributed from IRA accounts are taxed at ordinary income rates – often much higher than long-term capital gains rates. Assuming stocks compound at 8% and bonds at 4%, and tax rates for ordinary income is 35% and capital gains is 20%, if one were to redeem both accounts after 20 years the after-tax earnings would actually be $370,000 *greater* with Option 1!

Of course, this is a simplified illustration that ignores the effects of rebalancing, turnover, and dividends. The takeaway here is that it's not always appropriate to hold high growth assets (ie. stocks) in IRA accounts due to the adverse tax consequences from ultimately being treated as ordinary income. Additionally, equities held in IRA accounts lose the benefits of tax-loss harvesting and a step-up in basis upon death, and potentially lead to higher taxable distributions (RMDs) during retirement which may not be needed as well.

Being mindful of asset location goes far beyond how to allocate between stocks and bonds. In reality investors are faced with a number of asset classes and vehicles to choose from such as hedge funds, real estate, commodities, private equity, and more. Where possible, tax inefficient investments that generate short-term capital gains or interest income should be placed in tax-advantaged accounts like IRAs and 401(k)s, while tax efficient investments such as domestic stock ETFs or low turnover funds should be placed in taxable accounts. Doing so can lead to significantly higher after-tax returns.

Lunch, anyone?

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